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Youbou Sawmill

Analysis and Evaluation

Executive Summary

Undertaken for: Ministry of Forests

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June 2000

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Executive Summary

1 Introduction

TimberWest has advised the Ministry of Forests that it is trying to sell the Cowichan Lumber Operation (Youbou), together with TFL #46 and the Honeymoon Bay log sort. In the event that a sale is unsuccessful, TimberWest advises that the mill "will likely be placed into indefinite closure effective mid year 2000". Under the Mill Closure Review Process, the Ministry of Forests decided to obtain an independent review of the current and longer term operational and financial viability of Youbou and whether the current mill owner is justified in closing it. The review must be in the context of the ***current mill owner*** operating the sawmill under the conditions facing the coastal lumber industry.

This context precludes consideration of how the mill might be run under different ownership, where the log input, the products and markets could all be quite different.

The following review was undertaken by Drake and Associates during May 2000. In the absence of any previous feasibility analyses of the mill, the review is based on an analysis of TimberWest financial and operating reports for the past five years together with a critique of the product and marketing programmes that have been developed and an extensive evaluation of the timber supply to Youbou, the situation regarding TFL #46 and the current realities of the log export market. The mill was visited and discussions held with representatives from the IWA and from the local community

Two options have been identified by TimberWest, namely, sell the mill and TFL # 46 (the preferred option) or, failing that, likely close the mill indefinitely. The option of making a large capital investment to change the mill has been rejected and it appears clear to the consultants that TimberWest now has the overall objective of rationalizing the corporate assets to focus on its private timberlands investment.

In contrast, the IWA wants the mill operation to continue, either by TimberWest making new investment or as a stand alone operation with a new owner who would have the TFL #46 annual allowable cut free of any volume commitments to other parties. The union position is that, in addition to the poor quality of logs supplied, at least part of the reason for the lack of profitability is the lack of sufficient supply to run the operation throughout the year.

There are a number of important issues which have an impact on the evaluation of the mill. Fibre supply, mill operations, marketing programmes and the need for capital investment. Each of these is discussed below.

2 Fibre Supply

The mill is supplied with logs from a combination of sources. In 1998 and 1999, the following percentages applied;

TimberWest private timberlands	50%
TFL #46	33%
Vancouver Log Market (VLM)	15%
Local purchase	2%

The volume of logs supplied in the last two years has increased to an average of 470,000 m^3 per year from less than 300,000 m^3 per year in 1995 and 1996. Even with this increased volume the mill operating at below capacity.

The species and quality of the logs has been changing. Douglas fir is now predominant at around 60% and gang logs account for 80% of the input – much of which is now from second growth.

Logs from TFL #46 (where the AAC is currently about 460,000 m^3) that are not supplied to Youbou (mostly cedar and pulp) are supplied to other sawmills or chipping plants in exchange for chips under a fibre supply agreement with Fletcher Challenge Canada and for other reasons. This prevents the use of these logs to trade for supply of suitable logs to Youbou. In addition, there is a further encumbrance on the TFL #46 which removes all the cedar as a potential trade.

The logs to Youbou are towed directly from Honeymoon Bay. The logs from the private land and from TFL #46 are sorted at this location whereas the logs that are purchased (less than 20%) are backhauled from tidewater.

Log costs to the mill reflect the avoided cost of hauling from Honeymoon Bay to tidewater to sell on the VLM but we were told that, until recently, the haul from tidewater for purchased logs was not assessed against the mill. A detailed analysis of VLM prices for the grades that were processed over the years for the years 1995 to 1999 shows a close relationship between the cost shown in TimberWest financial statements and trends on the VLM. The Youbou costs were lower due, mainly, to the haul credit and the fact that a significant percentage of lower value second growth logs are included for Youbou.

3 Mill Facilities

The Youbou complex used to be quite extensive with kilns, boilers and a veneer plant, but it now consists of

- A mill – old technology, single cut band mill with a chipping side head and an exceptionally long 40' carriage. The second breakdown machine is a 12" bull edger where the saws have a heavy kerf.
- B Mill – canter-quad going to a fixed saw circular gang. Reasonably modern technology but lacks the now essential log scanning and optimizing ability that all modern small log lines must have.
- Reman area – both mills feed into a common reman area, much of which needs updating, and then to a good sorting system with two 50 bin sorters with a good software control system.
- Planer mill – old technology planer with insufficient capacity

There is some real concern that the foundations of A mill are in urgent need of repair. The problems are not new and have been mitigated by a continual maintenance effort. It is uncertain whether an immediate and significant capital cost must be incurred or whether the maintenance "quick fixes" can continue to suffice.

Examination of mill statistics shows that there has been a substantial improvement in many of the performance parameters over the last five years. The majority of the output is coming from B mill, which is run 2 shifts per day. A mill only produces about 25% of Youbou's output and is run on a one shift basis.

Though the number of operating days has increased significantly, the facility is still at only 216 days per year. The reason for this lower level in 1999 was said to be the lack of logs.

There is a good working relationship between management and the work force. A good part of the improvement in productivity from 1,441 board feet per manday in 1995 to 2,500 board feet per manday in 1999 is said to have resulted from the ability of the two parties to work together to find and implement efficiencies.

There has been very little capital spent on the mill since 1995 and it is becoming apparent that the mill is now in real need of a substantial capital injection if it is to compete in changing markets and with changing log supply. For example, over $2 million was spent in 1999 for custom processing products prior to shipment to the customer. Some additional investment in the necessary facilities at the mill should eliminate the need for this cost.

The cost of the modernization is variously quoted at anywhere between $8 million and $20 million. In our view, a level of around $10 to $12 million should provide a modern efficient B mill, including sufficient kiln capacity (depending on the product/market programme to be pursued).

4 Products and Markets

The type of fibre entering the mill precludes the development of any significant volume of clear and shop. Almost all the output is in merchantable grades. As a result, TimberWest have developed programmes which are aimed at capturing the optimum product/market/price mix that can be developed from the log. It appears, from our discussions with the sales people, that a wide variety of options have been looked at but the current approach appears the most suitable for the combination of log type and processing assets that presently exists.

At present, the objective for Douglas fir, which is now the majority of the output, is to utilise the ability to produce long lengths and timbers to satisfy the Belgian and Australian markets. These markets account for about 50% of the Douglas fir output and most of the balance is sold domestically. Much of the domestic sales is in terms of the falldown from the offshore programmes and is remanufactured into CLS dimension grades. Unfortunately, Youbou has no quota for sale to the US and must sell into the lower priced Canadian market.

In the case of hemfir, the mill is focused on the Japanese market. Since second growth yields relatively few baby squares, the main specification is various sizes of kompozai (a packaging item). However, TimberWest has linked in a number of other products to cover the spectrum of what develops from the log, e.g. items such as rail ties for Canada, scantlings for Australia and CLS for the local market.

Some small part of the volume sold domestically is remanufactured into high value products but we would expect that this volume would be fairly insignificant. The majority of the volume which is remanufactured is converted into CLS lumber for the construction market. Given the quality of the fibre which is provided to the mill, it is unlikely that there is a major high value remanufacturing opportunity being overlooked, however it is possible that there are other lower value remanufacturing opportunities which could be pursued. TimberWest marketing staff have indicated that many different programmes have been considered, including getting custom remanufacturing done where the mill equipment is inadequate. They advise that they have found that the current programme is the best approach under the market/price conditions that prevail at present.

It is possible that the availability of other equipment at the mill, for example kilns, as opposed to paying for custom processing, would change the relative values of different programmes.

5 Financial and Operating Statistics

Since this executive summary is not restricted circulation it is inappropriate to quote financial statistics in any detail. However, the key information that was apparent was the following.

The mill made very large losses from 1995 to 1997 but improved substantially in 1998 to show positive cash flow from operations. The amount of this positive contribution declined in 1999 and the mill is at around breakeven for the first quarter of 2000.

However, there are some costs which are borne by the head office which might logically be assessed against the mill. The principal of these is interest on working capital needed to fund receivables and the cost of log and product inventory. If this cost were added back, the apparent profitability of the mill in 1998 would be reduced substantially, eliminated in 1999 and 2000 would no longer be at breakeven.

In spite of this unprofitable history, Youbou appears reasonably competitive when compared with other mills on the coast. TimberWest commissioned a special study to compare Youbou against a number of other Coastal mills cutting similar species. The average profitability of these mills in 1997 and 1998 was negative and Youbou shows better results than about half of them. It ranks at #4 for operating earnings.

Specifically, Youbou has the lowest fibre cost (due to the haul credit and the lower value logs) but this is balanced by the lowest level of sales realisation (due to the lack of any valuable high grades). Lumber recovery is in the mid range of the competition and output per hour is ranked #3 of the eight.

A similar result is obtained when comparing the Youbou data against the Price Waterhouse Cooper Annual report on the forest industry. The BC Coastal lumber industry has been showing minimal or negative earnings over recent years. However, it should be noted that there had been some profitable years earlier at a time when the Youbou results were particularly poor (1993 to 1996).

In summary, though the Youbou financial results do not show any profit, it appears that this is a common condition for half the coastal industry.

6 Outlook

The outlook for available fibre in the area is for increasing proportions of small and second growth logs. Furthermore, the availability from TFL #46 will be increasingly Douglas fir.

From the market point of view, there is some considerable concern about the future of the programmes which are being pursued by TimberWest.

> The Belgian market for Douglas fir is coming under increasing long term pressure from the French sawmills; though next year may be good.
>
> The Australian market is changing; there is a rapid increase in the use of engineered wood products and there is a substantial increase due in the supply of plantation radiata pine.
>
> The Japanese market is moving to increasing volumes of dried product and any mill serving this market must have drying capacity.
>
> The theoretically bright spot should be the US market. With the almost certain collapse of the quota concept, Youbou will no longer be suffering under the major disadvantage that has faced it for the past four years and will be able to sell into this market. However, it is projected that the prices in the US market will decline from the levels enjoyed last year. For example, S-P-F, which tends to be a useful indicator of construction lumber prices generally, is projected to be at around $300 per MBF over the next three years, compared with about $345 average for the year in 1999.

None of this is good news for the Coastal industry and recent publicity about the very poor future for the industry and the need for some major structural changes are very appropriate.

The one optimistic note, at least from the point of view of a sawmill, is that log prices are expected to decline by 8% to 15%, as a result of the lower market prices for product, therefore the loss of return will be offset to some extent by lower wood costs.

7 Conclusion

In terms of both operational and financial viability, within the TimberWest framework, our review indicates that mill closure does not appear to be a critical immediate necessity. Many operations have been kept going in the face of worse losses than are apparent with Youbou. However, profitability is not only low, it is effectively negative if the cost of interest on full working capital requirements is assigned to the mill.

Furthermore, the outlook for the market is not encouraging (there is little indication of higher returns and increased volumes) and there may be some significant capital expenditures needed in the immediate future, simply to keep the mill operating. In addition, the mill is not currently well suited for the small logs which will be available in the future and will need substantial capital investment, which can't be justified by past financial performance. A number of knowledgeable mill people and financial analysts have reviewed the situation at Youbou and have concluded that such a capital investment would not be viable.

Consequently, we have to conclude that TimberWest is making a sound corporate decision in deciding to close the operation – particularly bearing in mind the priorities of the corporation relative to private timberlands and log exports.

At the same time, the mill is competitive in the context of the coastal industry. The combined efforts of management and labour have dramatically improved productivity and profitability over the past five years and in 1998, while the BC coastal industry showed negative results, Youbou provided a profit – even though the mill was working on low grade logs.

Though we did not undertake any detailed analysis of alternative operating approaches, we were asked to comment on whether options other than closure might exist. In spite of the views of some financial analysts, we believe that, under different ownership, which has different priorities, the mill might possibly be economically viable. It would be critical that such an owner has long term fibre security – such as TFL #46 without any encumbrances – and operates the Honeymoon Bay log sort.

For example, a new owner could consider the economics of closing and dismantling A mill and modifying B mill into an efficient small log sawmill. This approach would recognise that TFL #46 is becoming predominantly second growth and has a high proportion of Douglas fir. Assuming that the US quota no longer exists, an important future programme for such a mill could be green dimension Douglas fir to the US. However, drying would also be necessary for other programmes and the owner would have to consider how to mitigate the disadvantage of having no access to natural gas.

There could be other approaches which might include a greater degree of processing but it has been outside our mandate to consider a full range of opportunities.

In conclusion, we agree that TimberWest is justified in closing the mill. However, under the right circumstances there might be a continued operation at Youbou.